**REPORT #570**

**TAX SECTION**

# New York State Bar Association

COMMENTS ON CODE §469(k)(3)

Report of the Partnership Committee

September 23, 1987

## Table of Contents


Cover Letter 1: ... i

I. The Scope of Treasury's Authority under Section 469(k)(3) ... 1

Introduction: ... 1

Publicly Held Partnerships: ... 4

Example 1 ... 6

Non PHP Limited Partnerships ... 7

Example 2A ... 8

Example 2B ... 10

Example 2C ... 10

Rental Activities: ... 11

Example 3A ... 11

Example 3B ... 12

Example 3C ... 12

Example 3D ... 13

OFFICERS
DONALD SCHAPIRO
Chairman
26 Broadway
New York City 10004
HERBERT L. CAMP
First Vice-Chairman
30 Rockefeller Plaza
New York City 10112
WILLIAM L. BURKE
Second Vice-Chairman
One Wall Street
New York City 10005
ARTHUR A. FEDER
Secretary
1 New York Plaza
New York City 10004

CHAIRMEN OF COMMITTEES
Alternative Minimum Tax
Eugene L. Vogel, New York City
William H. Weigel, New York City
Bankruptcy
Peter C. Canellos, New York City
Robert J. McDermott, New York City
Commodities and Financial Futures
Robert S. Fink, New York City
Michelle P. Scott. Newark N.J.
Continuing Legal Education
Victor F. Keen, New York City
Sherry S. Kraus, Rochester
Corporations
Kenneth H. Heitner, New York City
Richard L. Reinhold, New York City
Criminal and Civil Penalties
Sherman F. Levey, Rochester
Charles M. Morgan. III, New York City
Depreciation and Investment Credit
William F. Indoe, New York City
Bruce M. Montgomerie, New York City
Employee Benefits
Stephen M. Piga, New York City
Estate and Gift Taxes
Linda B. Hirschson, New York City
Carlyn S. McCaffrey, New York City
Exempt Organizations
Sydney R. Rubin, Rochester
Financial Institutions
Richard M. Leder, New York City
Harry E. White, New York City
Foreign Activities of U.S. Taxpayers
Matthew M. McKenna, New York City
Victor Zonana, New York City
Income of Estates and Trusts
Henry Christensen, III, New York City
Jerome A. Manning, New York City
Income From Real Property
Sherwin Kamin, New York City
Ronald A. Morris, New York City
Insurance Companies
Hugh T. McCormick, New York City
Interstate Commerce
Robert E. Brown, Rochester
James H. Peters, Basking Ridge. N.J.
Net Operating Losses
James M. Peaslee, New York City
Matthew A. Rosen, New York City
New York Tax Matters
Robert J. Levinsohn, New York City
Michael H. Simonson, New York City
New York State Tax Maters
William M. Colby, Rochester
Arthur R. Rosen, Morristown, N.J.
Partnerships
Robert A. Jacobs, New York City
R. Donald Turlington, New York City
Personal Income
Michael L. Schler, New York City
Steven C. Todrys, New York City
Practice and Procedure
Michael I. Saltzman, New York City
Sterling L. Weaver, Rochester
Problems of the profession
Richard J. Bronstein, New York City
Laraine S. Rothenberg, New York City
Reorganizations
James A. Levitan, New York City
Stanley I. Rubenfeld, New York City
Sales, Property and Miscellaneous
E. Parker Brown, II, Syracuse
Paul R. Comeau, Buffalo
Tax Accounting Matters
James S. Halpern, Washington, D.C.
George E. Zeitlin, New York City
Tax Exempt Bonds
Jackson B. Browning, Jr., New York City
Dennis R. Deveney, New York City
Tax Policy
Alan W. Granwell, Washington, D. C
Richard O. Loengard, Jr., New York City
Unreported Income and Compliance
Donald C. Alexander, Washington. D.C.
Mark L. McConaghy, Washington. D.C.
U.S. Activities of Foreign Taxpayers
Cynthia G. Beerbower, New York City
John A. Corry. New York City

REPORT #570

**TAX SECTION**

# New York State Bar Association

**MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE**

M. Bernard Aidinoff, Roger J. Baneman, Robert J. Cubitto, James S. Eustice, Micheal L. Friess, Patricia Geoghegan, Thomas V. Glynn, Michael Hirschfield, Emily F. Johnson, Edward D. Kleinbard, Barbara Klippert, Richard Koffey, Irving Salem, Mary F. Voce, David E. Watts

September 25, 1987

BY FEDERAL EXPRESS

Hon. Laurence B. Gibbs
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I enclose our report concerning the Passive Loss Provisions under Code §469, prepared by Robert A. Jacobs and R. Donald Turlington, co-chairs of the Partnership Committee, The Report has been approved by the Executive Committee of the Tax Section.

Helpful comments were received from William Be. Brannan, Herbert L. Camp, Michael J. Close, Jill E. Darrow, James K. Dreyfus, Peter M. Fass, Simon Friedman, Gary I, Fritzhand, Martin T. Goldblum, Richard J. Hiegel, Michael Hirschfeld, Richard Lipton, Leslie H. Loffman, Lee S. Parker, Joel A. Poretsky, Sanford C. Present, Donald Schapiro, Norman Sinrich, Steven C. Todrys, William H. Weigel and Isaac W. Zisselman.

The Report focuses on Code §469(k) (31, authorizing regulations requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity. We appreciate this is a difficult assignment. No solution reviewed by us brought forth readily applicable or fully satisfying answers. Given the avowed purpose of the passive loss provisions to prevent undue sheltering of earned and portfolio income, we believe the rules proposed here - as a set - achieve the Congressional purpose without

**FORMER CHAIRMEN OF SECTION**

Howard O. Colgan, Charles L. Kades, Charles J. Tobin, Jr., Carter T. Louthan, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey, Jr., Charles E. Heming, Richard H. Appert, Ralph O. Winger, Hewitt A. Conway, Martin D. Ginsburg, Peter L. Faber, Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, Ruth G. Schapiro, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen

imposing undue hardship or unfairness upon taxpayers. We emphasize the solutions proposed here are a single structure endorsed as such and not endorsed severally by the New York State Bar Association Tax Section.

The key to our proposal is to treat publicly held partnerships (to be defined by membership size or public trading) as producing per se portfolio income, rather than passive income. We believe the implementation of this rule would achieve substantially all the goals envisioned by Congress in enacting Code §469(k)(3) and therefore believe that other nominally passive income should retain its passive income characterization, except where the income derived by the limited partners is from a partnership interest, substantially all of the value of which is attributable to a preferred and limited income stream, made possible by significant capital or credit supplied by other partners.

Sincerely,

Donald Schapiro

Enclosure

Copies of this letter and report to persons on the attached list

William F. Nelson, Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Hon. O. Donaldson Chapoton
Acting Assistant Secretary for Tax Policy
Treasury Department
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dennis Ross, Esq.
Tax Legislative Counsel
Treasury Department
3064 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Hon. David H. Brockway
Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, DC 20515

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth Building
Washington, DC 20515

James Clark, Esq.
Minority Tax Counsel
House Ways and Means Committee
1106 Longworth Building
Washington, DC 20515

William Wilkins, Esq.
Chief of Staff and Chief Counsel
U.S. Senate Committee on Finance
205 Dirksen Office Building
Washington, DC 20510

John Colvin, Esq.
Minority Chief Counsel
U.S. Senate Committee on Finance
G-08 Dirksen Office Building
Washington, DC 20510

TAX REPORT #570

September 23, 1987

# NEW YORK STATE BAR ASSOCIATION

## TAX SECTION

## COMMENTS ON CODE §469(k)(3)

## Report of the Partnership Committee[1/]

## I. The Scope of Treasury's Authority under Section 469(k)(3)

### Introduction:

The 1986 Tax Reform Act (the "TRA") attacks tax shelters by limiting the deductibility of passive losses. Under Code §§469(c)(1) and (h)(2), a limited partner's income or loss from a trade or business conducted by a limited partnership is passive activity income or loss. Code §469(c)(2) adds that rental activity income or loss is passive income or loss.

After the Senate passed its version of the TRA, concern developed that promoters and investment bankers could organize and market limited partnerships that would produce passive income that could be sheltered by otherwise non-deductible passive

---

1/ This report was prepared by R. Donald Turlington and Robert A. Jacobs, co-chairs of the Partnership Committee. Contributions were also made by William B. Brannan, Herbert L. Camp, Michael J. Close, Jill E. Darrow, James K. Dreyfus, Peter M. Fass, Simon Friedman, Gary I. Fritzhand, Martin T. Goldblum, Richard J. Hiegal, Michael Hirschfeld, Richard Lipton, Leslie H. Loffman, Lee S. Parker, Joel A. Poretsky, Sanford C. Present, Donald Schapiro, Norman Sinrich, Steven C. Todrys, William H. Weigel and Isaac W. Zisselman. Many contributors disagree with the report's conclusions -- in whole or in part.

losses. These limited partnerships would produce passive income that could be sheltered with otherwise unusable passive losses. Properly packaged, these investments could provide some investors who own or purchase passive loss producing activities with attractive alternatives to investing in stocks and bonds that produce non-shelterable portfolio investment income.

To enforce the purpose of the passive loss rules -- to prevent sheltering of positive income sources by losses from unrelated activities -- Congress, in Code §469(k)(3), delegated to Treasury the authority to classify net income or gain from a limited partnership or other passive activity as not from a passive activity. We appreciate that writing the regulations to carry out that Congressional mandate is not easy. Much of the difficulty eminates from attempting to distinguish certain types of passive income from portfolio income -- a distinction that, at best, is murky. In economic and business terms, net leases may not materially differ from ground leases, but the Conference Report II-138 states net leased property is a rental activity producing passive income, while the Blue Book at 235 suggests income from ground leases should be treated as portfolio income.

In the context of limited partnerships engaged in active businesses, how the Treasury should exercise its

delegated authority is less than clear. At one extreme, Treasury could promulgate regulations that would characterize any positive income realized by limited partners from limited partnerships engaged in an active business as other than passive income (presumably coming within the portfolio income definition). Conversely, Treasury could determine that all positive income realized by limited partners from limited partnerships engaged in an active business should constitute passive income of a non-participating limited partner, relying on the statutory definition that an activity is a passive activity, producing passive income, if the activity involves the conduct of any trade or business and if the taxpayer does not materially participate in the activity. We agree with neither of these polar positions.

In summary, we recommend that positive income generating limited partnerships engaged in an active business be deemed to produce passive income with two exceptions. The first exception would provide that "publicly held" limited partnerships generally produce portfolio income. The second exception would be applied on a case-by-case, partner-by-partner, basis to convert a limited partner's otherwise passive income derived from a limited partnership to portfolio income where the facts and circumstances of the specific case show that substantially all (say, more than 80%) of the value of the limited partner's limited

partnership interest at the end of the year the interest is acquired is attributable to a projected preferred limited income stream, the income stream preference being made possible by significant credit or significant capital supplied by other partners.

Publicly Held Partnerships:

We recommend Treasury promulgate a per se rule under its Code §469(k)(3) authority that income derived by limited partners from their publicly-held partnerships ("PHPS") be considered portfolio income. We would define PHPs to mean publicly traded limited partnerships and limited partnerships whose membership size exceeds a numerical benchmark to be established, e.g., 100 or 1000 partners.[2/] We believe these PHP interests are sufficiently "portfolio income flavored," to justify characterizing their income as portfolio income

---

[2/] In determining whether the benchmark has been reached, all members of various tiered partnerships should generally count. When a preexisting partnership makes an investment, e.g. where a law firm investing partnership purchases an interest in an otherwise private, e.g. 10 partner partnership, the investing partnership should probably be counted as a single limited partner. Appropriate attribution rules should treat family and other related owners of limited partnership interests as a single partner.

under the delegated statutory authority.[3/]

Although this suggested broad general bright line rule may reach some classic business ventures actively conducted in partnership form, we believe the resemblance to portfolio income (i.e., dividends interest and royalties) is sufficient to classify all PHP generated income as portfolio income.

All PHP net losses should, however, be treated as passive losses. Where a given PHP produces net income and net losses in various tax years, the PHP net income allocated to a limited partner in any taxable year would be passive income to the extent that income (plus all prior income from that partnership) does not exceed cumulative prior losses from that partnership allocable to that partner. Income in excess of cumulative prior losses would be portfolio income. For example, assume a PHP that allocates active operating losses (treated as passive losses) of $100 to Partner A in year 1 and active operating profit (treated as portfol.io income) of $70 to Partner

---

[3/] A substantial minority of Executive Committee members would not apply to per rule to income derived by limited partners from limited partnerships engaged in traditionally passive activities, e.g., real property net leasing.

A in year 2. In year 2, A'S $70 of partnership income is treated as passive income. Similarly, if the PHP allocated active operating income (treated as portfolio income) of $70 to Partner A in year 1 and active operating losses (treated as passive losses) of $100 to Partner A in year 2, Partner A's year 2 passive losses should be allowed as a deduction against any other income to the extent of $70. The remaining $30 of year 2 loss would be passive loss.

Much of the difficulty (and controversy) of characterizing PHP income could be resolved by amending Code §469 to create a fourth basket of income and loss. In addition to the present compensation, passive and portfolio income and loss baskets, a "Publicly Held Partnership" income and loss basket could be established, into which all PHP income and loss would be placed.

Example 1

PHP is formed to succeed to a profitable operating business previously operated as a division of X, a publicly traded corporation. X contributes the business to the PHP, together with liabilities , in exchange for a 50% capital , profit and loss interest as a general partner in the PHP's capital. The investors, in a public offering, contribute cash for an equal interest in the PHP's capital, the cash being used to pay general indebtedness of the business owed at the time of its transfer to PHP. The limited partnership

interests are traded on the New York Stock Exchange or the number of limited partners exceeds the benchmark number. PHP reports taxable income.

While under the general rules of Code §§469(c)(l) and (h)(2), the PHP income allocated to limited partners would be passive income, we believe Treasury should invoke its authority under Code §469(k)(3) to classify the PHP income (in excess of passive losses of that PHP allocated to the taxpayer partner) as portfolio income. The PHP interests are publicly traded or widely held in the manner of portfolio securities and should be so classified -- for income purposes only.

Any PHP losses should be treated as passive losses, available to offset any subsequent income of that PHP.

Non PHP Limited Partnerships

If limited partnership interests are neither publicly traded nor held by a number of partners greater than the established benchmark number, income derived by the partnership from its active business and allocated to the limited partners should ordinarily be passive income. But, the income stream should he treated as portfolio income if substantially all (more than 80%) of the value of the partnership interest measured at the end of the year during which the limited partnership interest was purchased is attributable to a preferred and limited income

stream made possible by significant credit or significant capital supplied by other partners.

Example 2A

A limited partnership is formed to purchase and operate a retail clothing business. Fifty percent of the capital is contributed to the partnership by its general partner. The balance is contributed by fewer than the benchmark number of investors pursuant to a private placement. The partnership agreement allocates 99% of partnership income to the investors until they have received a 10% cumulative return on their invested capital. Remaining income is allocated to the general partner until the aggregate income allocated to the general partner equals the income allocated to the investors. All remaining income is allocated 10% to the investors and 90% to the general partner.

In this example, the general partner has subordinated its income interest to the 100% minimum income return of the limited partners. Under the rule proposed, Code §6469(k)(3) would be invoked by Treasury to classify the priority income allocated to the investors as portfolio income, rather than passive income, if on the facts, more than 80% of the value (on a present value basis) of the limited partners' entire interest at the end of the year during which the interest was purchased is attributable to

the 10% priority return. In all events, if the limited partners also receive any of the 10% residual allocation, that allocation -- not senior to any subordinated interest -- should be treated as passive income.

Assume the facts in Example 2A were changed so that the store was begun as a start-up operation with the expectation that losses would be experienced in the early years, which expectation was realized. Thus, the limited partners were allocated net losses in the early years. In later years, as projected, the operation became profitable.

Under the proposed rule, the losses in the initial years should be characterized as passive losses to prevent sheltering of unrelated nonpassive income (i.e. dividends and interest). The taxable income earned in later years and allocated to the limited partners who were allocated the earlier losses should be characterized as passive income to the extent of prior passive losses from that activity and income in excess of prior losses would be treated as portfolio income because the test that takes the case out of the general rule remains applicable, viz more than 80% of the value of the limited partner's interest is attributable to a preferred and limited income stream made possible by credit or capital supplied by another partner.

We recognize that applying the Treasury's authority under Code §469(k)(3) to reach this result would be

virtually the same as a tracing concept for activities, an approach rejected in prior revenue acts because of "its extreme complexity and its adverse economic impact." See discussion of Limitation on Artificial Losses included in the House version of the 1976 Tax Reform Act by the Senate Finance Committee. S. Rep. No. 94-938, 94th Cong. 2d Sess. (June 10, 1976) at 39.

Example 2B

Assume the partnership agreement in Example 2A did not provide a priority allocation of partnership income to the investors. Instead, all income and losses are allocated in proportion to invested capital.

The general rule would apply and the income derived by the partnership and allocated to the investors would be passive income. The limited partners have no preferred and limited income stream.

Example 2C

Assume the same facts as in Example 2A, except 90% of the partnership's capital came from the investors and the investors are entitled to receive a priority and cumulative 10% return on their investment out of partnership income before any income is allocated to the general partner. After the investors have been allocated income equal to 10% of their investment, the remaining income is allocated 50% to the limited partners and 50% to the general parther.

The general rule would apply and the income derived by the partnership and allocated to the investors should be passive income. Here the limited partners' priority income stream is not backed by significant credit or significant capital supplied by other partners.

Rental Activities:

Example 3A

A limited partnership is formed to purchase and lease commercial aircraft. The partnership interests are held by fewer than the benchmark number of limited partners. Each aircraft will be purchased for cash, substantially all of which will be contributed by individual limited partners. Each aircraft will be net leased to a major airline for a term sufficient to return the full cost of the aircraft plus a small profit. Most of the anticipated profit is expected to be derived from the sale or re-lease of the aircraft at the end of the initial lease term. The transaction qualifies as a lease and not a financing for tax purposes. The partnership likely will earn taxable income each year during its existence. There is no distinction between the classes of partners and gain/loss income and cash flow is allocated on the basis of capital contributed.

The activity should be treated as giving rise to passive income on the basis of the characterization of the transaction as a lease (and not a financing) of personal property.

The risks and rewards of ownership of property remain with the partnership, end there is no inter-partner division or allocation subdividing risk or reward.

Example 3B

A Limited partnership is formed to purchase and net lease land and building for 99 years to a credit worthy tenant. The capital and profits and loss interests are allocated 99% to the limited partners.

In this example, although the bulk of the value of the limited partnership interest is attributable to a limited income stream, because that income stream is not preferred and is not backed by significant creditor capital supplied by other partners, the income should be treated as passive income.

Example 3C

Assume the airplane leasing partnership in Example 3A purchased aircraft to rent to private noncommercial lessees. The leases are short-term, i.e., less than one-half of the ACRS useful life of each aircraft. The partnership remains responsible for repairs and maintenance. As each lease terminates, the lessee is given the right to re-lease or purchase the aircraft at its then fair market rental or sale value. While the partnership expects to earn an overall profit during its existence, there is no assurance that the partnership will earn a profit in any

year or over its life because the partnership's profit or loss will depend upon the re-lease or sale value the aircraft and minimization of operating expenses.

In this case, the partnership's rental business is an active leasing business. The investor's income should be passive income. Note that in this Example involving an active business (as well as in Example 3A involving a net lease) the result could change if there were different classes of partners and the partnership agreement, as in Example 2A, provided the limited partners with a preferred and limited return made possible by significant capital or credit supplied by the general partners.

Example 3D

Assume the major airline leasing partnership in Example 3A borrowed 50% of the cost of each aircraft from an unrelated institutional lender. As a result, the partnership projects tax losses for several years. Thereafter, it hopes to generate substantial taxable income. During the initial lease term, the investors expect to receive 8% cash flow each year on their invested capital. They expect to receive the remainder of their return (anticipated to be no less than a commercial interest rate) from the sale or re-lease of the aircraft.

In this case, the taxable income allocable to the investors should be characterized the same as the income in

Example 3A, i.e., as passive income. The leverage produced by the borrowing merely reduces the current cash flow yield to the investors. It does not materially change the character of the investment. The losses sustained by the Partnership should be characterized as passive lossess.

******

We appreciate the difficulty of the task assigned to the Treasury Department. Developing regulations that provide guidance and certainty -- or even safe harbors -- for a statute that attempts to distinguish among cases that are often indistinguishable is not an easy project. We urge the Treasury to avoid, to the extent practicable, the uncertainty these questions invite and to extend passive income treatment to the bulk of passive activities described in Code §469(c), recognizing the full limits of Treasury's authority have not been exercised. That restraint would seem to us to be consonant with the legislative purpose and the revenue goals that fostered these provisions and consistent with the sound administration of the tax law.

The approach we recommend is intended to adopt workable rules while providing significant restraint on the proliferation of partnerships designed to thread their way to passive income with a high portfolio flavor. The PHP rule and suggested testing of preferred, limited interests made possible by subordinated

capital contributions or guarantees provided by other partners may produce a lack of certainty at the border, but should create minimal uncertainty as to virtually all income generated by limited partnerships. In almost all cases involving limited partners in limited partnerships engaged in active business or rental activities under the rules suggested, limited partnerships that are not PHPs and do not significantly subordinate various partnership interests will produce passive income for their partners. This is as it should be, protecting the legitimate interests of both the Treasury and investors.